

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION OF ASHLAND)	CASE NO. 91-396
EXPLORATION, INC.)	

O R D E R

On October 31, 1991, the Commission initiated this proceeding to investigate the rate increase of Ashland Exploration, Inc. ("Ashland") to its domestic end-use customers ("farm taps"). Ashland provides service to these customers pursuant to KRS 278.485 and lease or right-of-way contracts. According to complaints filed with the Commission, Ashland's proposed rate increase of \$5.25 per Mcf was to be effective November 1, 1991, and Ashland planned to disconnect gas service to any customer who failed to return a signed contract accepting the proposed rate by October 31, 1991.

In its October 31, 1991 Order, the Commission directed Ashland to maintain its existing rate and to reconnect any customers whose service had been terminated for failure to sign a contract. On that same date, Ashland notified its customers that the increase in rates would not take effect as planned.

Pike County Citizens United for Justice ("Citizens") and the Office of the Attorney General ("Attorney General") intervened in this proceeding.

BACKGROUND

Prior to the Commission's initiation of this proceeding, Citizens filed a complaint with the Federal Energy Regulatory Commission ("FERC") asserting that Ashland's proposed action terminated or ignored gas purchase contracts between Citizens' members and Ashland. Citizens represents customers who were previously served by OXY USA ("OXY"). After Ashland purchased certain OXY gas properties in Kentucky in 1990, Ashland became the provider of service to these customers.

Ashland serves approximately 2,000 customers, of whom 960 are former OXY customers. Of these, 370 receive service pursuant to right-of-way or lease contracts. The remaining customers have been served by Ashland for many years. According to Ashland, the 370 former OXY right-of-way or lease customers are currently charged 35 cents per Mcf; the remaining former OXY customers' rate is \$3.09; and the rate to Ashland's remaining customers is \$3.30.¹

On January 13, 1992, the Commission held Ashland's motion to dismiss this case in abeyance and canceled a scheduled hearing pending the FERC's ruling on Citizens' complaint. On April 14, 1992, the FERC dismissed Citizens' complaint and denied its request for a hearing.² On June 3, 1992, Ashland reinstated its motion to dismiss this proceeding based on federal preemption. A hearing was

¹ Transcript of Evidence ("T.E."), January 6, 1993, pages 101-102.

² Docket No. GP 92-7-000, Pike County Citizens for Justice v. Ashland Exploration, Inc., Order issued April 14, 1992.

held on the motion and, in its July 24, 1992 Order, the Commission denied Ashland's motion to dismiss.

A prehearing conference on the issues, jointly requested by Ashland and Citizens, was held August 7, 1992. Information requests to Ashland were issued August 28, 1992 by the Commission and Citizens. On September 28, 1992, Citizens filed a motion to compel certain additional information from Ashland. At an October 15, 1992 hearing the Commission ordered Ashland to provide part of the additional information, including a cost-of-service study. On December 10, 1992, the Commission issued an information request to Citizens. A hearing was conducted January 6, 1993, and all parties filed briefs February 23, 1993.

ISSUES

After a review of the record, the Commission concludes that decisions are required on three specific issues: whether the Commission has jurisdiction over the rates of Ashland's farm tap customers; whether Ashland's proposed increase in rates to \$5.25 is fair, just, and reasonable; and whether the Commission's decision on Ashland's proposed rate increase should apply to the 370 former OXY customers served and charged rates pursuant to right-of-way or lease contracts.

Commission jurisdiction over Ashland's rates to its farm tap customers is based upon KRS 278.485, KRS 278.040, and applicable sections of the Natural Gas Policy Act of 1979 ("NGPA") as amended. The Commission also finds that Ashland's fair, just, and reasonable rate to its farm tap customers should be \$3.463 per Mcf. However,

this increase should be deferred for the 370 former OXY customers served pursuant to right-of-way or lease contracts pending the conclusion of litigation filed by Citizens in federal court.

Jurisdiction

Ashland asserts that the Commission lacks jurisdiction over its rate to its farm tap customers because of federal preemption of "state statutes, cases and regulation."³ Ashland acknowledges that KRS 278.485 grants the Commission regulatory jurisdiction over a gas producer when the producer is required to provide service to persons under certain conditions. However, Ashland contends that, as the FERC found that Ashland's sales to its farm tap customers are "first sales" of natural gas as defined by the NGPA at Section 301(21)(A)(iii), "the FERC has exclusive authority to set the maximum lawful price that may be charged for the sale of such gas."⁴ Ashland also notes that the FERC approved Ashland's weighted average pricing methodology for gas sold to its farm tap customers.⁵

Ashland relies upon Public Service Commission v. FERC, 610 F.2d 439 (6th Cir. 1979) to support its contention that the FERC maintains exclusive jurisdiction over its rates, thereby preempting Commission jurisdiction. In Ashland's opinion, even though its farm tap customers are served from gathering pipelines, the FERC's

³ Memorandum in Support filed in its Motion to Dismiss and to Delay Answers to Data Requests and Hearing, December 2, 1991, page 10.

⁴ Id., page 10.

⁵ 17 FERC (CCH) § 61305 (1981).

jurisdiction applies because its gas operations are interstate in nature.

Ashland also cites the Commission's previous decision in Case No. 10038.⁶ Ashland interprets the Commission's decision there as a recognition of the FERC's jurisdiction over the issues considered in that proceeding.

In its July 24, 1992 Order, the Commission addressed the issue of Ashland's rates and federal preemption. While the NGPA gives the FERC authority to set the maximum lawful price for interstate gas, once authority is granted to divert gas from the interstate stream for domestic customers, KRS 278.485 and KRS 278.040 give the Commission authority to determine the fair, just, and reasonable rate for such customers.⁷

Furthermore, in its reference to the NGPA, Ashland ignores certain authority granted to a state. Section 602 clearly provides that a state may establish or enforce maximum lawful prices lower than those under the NGPA for first sales of gas produced in that state.⁸ The Commission agrees that Ashland's sales to its farm tap

⁶ Case No. 10038, Abandonment of Gas Service by Ashland Exploration, Inc. and Barnes Transportation Company, Inc. (1987).

⁷ Order entered July 24, 1992 in Case No. 91-396, An Investigation of Ashland Exploration, Inc., page 3. Furthermore, the FERC granted Ashland authority to abandon certain volumes of gas for existing domestic users in Docket Nos. G-3913-001, et al., Order issued June 18, 1981.

⁸ Effective January 1, 1993, Section 602 of the NGPA was amended to say: "Nothing in this Act shall affect the authority of any State to establish or enforce any maximum lawful price for the first sale of natural gas produced in such state." (Emphasis added.)

customers are "first sales" as defined in the NGPA and acknowledges that the FERC has approved Ashland's weighted average pricing methodology as complying with the NGPA. While the weighted average pricing methodology can be used by Ashland to determine the price for its gas, the Commission can, pursuant to Section 602 of the NGPA, establish a rate lower for Ashland's "first sales" gas. In the alternative, if the weighted average price is found reasonable, the Commission may enforce that price. Pennzoil Co. v. Public Service Commission, 327 S.E.2d 444 (W.Va. 1985), cert. denied, 474 U.S. 822 (1985).

Ashland's reliance upon the Sixth Circuit ruling in Public Service Commission v. FERC is misplaced. There, the Court held that the Commission could not order an interstate pipeline to divert gas from interstate commerce for use by Kentucky consumers. However, in 1981 the FERC approved the abandonment of certain volumes of Ashland's natural gas which had been dedicated to interstate commerce,⁹ and Ashland acknowledges that the purpose of its application to the FERC was to "seek abandonment from interstate commerce the requisite gas volumes . . ." to supply its existing local customers.¹⁰ Once abandonment authority is granted, as the FERC ordered in 1981 regarding the gas volumes Ashland currently supplies to its farm tap customers, KRS 278.485 and KRS 278.040 become applicable.

⁹ 17 FERC ¶ 61,305 (1981).

¹⁰ Ashland's Memorandum in Support, page 4.

Finally, Ashland misinterprets the Commission's decision in Case No. 10038. In its Order, the Commission dismissed the matter under consideration because KRS 278.485 grants a gas pipeline company the authority to abandon any gathering line or gas well. The basis for the Commission's dismissal related to the provision in KRS 278.485(6) which specifically grants certain abandonment authority to gas pipeline companies, not that federal authority granted Ashland such right. The issues in Case No. 10038 and this proceeding are unrelated.

While gas pipeline companies such as Ashland have the authority pursuant to KRS 278.485 to abandon any gas well or gathering pipeline, KRS 278.485 also grants the Commission specific authority to determine the rates for gas service provided by such companies. In addition, based upon the most recent amendment to Section 602 of the NGPA, the Commission has the authority to set any price for any of Ashland's "first sales" gas, whether such gas is sold to its farm tap customers or sold to its wholesale customers. For the reasons stated herein, the Commission's authority to determine rates for Ashland's farm tap service is not preempted by federal authority.

Ashland's Proposed Rate

Ashland's proposed rate of \$5.25 per Mcf is based upon the weighted average price for all the gas it produces and sells to its farm tap customers. At the time the rate increase was proposed, 70 percent of Ashland's gas was subject to various maximum lawful

price ceilings,¹¹ for which the average price was \$6.39. As the price ceilings for the remaining 30 percent were already deregulated, Ashland used \$2.60, the price it received for its wholesale sales under certain contracts at that time, for this gas.¹² The resulting weighted average price is \$5.27. In Ashland's opinion, the proposed rate establishes its maximum lawful price and meets the standard the Commission has used in previous cases, i.e., the relevant maximum lawful price, to approve other producers' rates for their farm tap customers.

In support of its proposed rate, Ashland also filed a cost-of-service study.¹³ The study is comprised of two components: a \$2.10 "cost of product" which according to Ashland is identical to the negotiated wholesale price it collects from its wholesale customers;¹⁴ and a series of schedules (Nos. 2 through 13) representing various categories of costs which Ashland asserts it incurs for farm tap service. These categories are: operating costs, depreciation of equipment, production foreman costs, district office costs, region office production costs, gas sales costs, legal costs, direct accounting labor costs, bad debt

¹¹ Statement of Basis for Proposed Increase submitted August 4, 1992, page 2. Effective January 1, 1993, these remaining price ceilings were eliminated.

¹² Id., page 3.

¹³ Response of Ashland Exploration, Inc. to Pike County Citizens United for Justice Request for Information, Request No. 15, filed November 25, 1992.

¹⁴ Brief of Ashland Exploration, Inc., filed February 23, 1993, page 9.

reserve, general and administrative costs, and interest costs. In calculating its proposed rate, Ashland also included a 15 percent return on its expenditures. Based upon this study, Ashland's total cost to provide farm tap service including the 15 percent return is \$6.101 per Mcf.

Ashland acknowledges that the accounting records which support its cost-of-service study are kept in a manner reflecting its principal business--exploration and production of oil and gas. As its records are not maintained according to the Uniform System of Accounts ("USoA") required of local distribution utilities subject to Commission jurisdiction, Ashland derived certain costs through allocations based upon either the percentage of time spent on domestic retail projects or on sales volume percentages.

Citizens asserts that Ashland should be allowed a rate no greater than the price it would receive at wholesale, plus proven incremental costs incurred solely for farm tap service, less costs incurred in the wholesale market but not incurred with farm tap service.¹⁵ Both Citizens¹⁶ and the Attorney General¹⁷ argue that Ashland's cost-of-service study is flawed because it counts certain expenses twice by adding various allocated production costs already included in the wholesale price to the wholesale cost of gas. In addition to the cost-of-service rate, Citizens argues that other

¹⁵ Brief of Pike County Citizens United for Justice filed February 23, 1993, pages 4-6.

¹⁶ Id., page 5.

¹⁷ Brief of the Attorney General filed February 23, 1993, page 1.

factors should also be considered in determining the appropriate rate, such as Ashland's "historic course of dealing and the fact that many of Ashland's customers are elderly and on a fixed income"18

Citizens presents an alternative cost-of-service which concludes that Ashland's rate should be either \$2.081 or \$3.043, depending upon how Ashland's average wholesale price for gas is calculated and what particular costs are excluded. According to Citizens, Ashland should be allowed to make the same profit on its farm tap sales as it makes on its sales to wholesale customers. The Attorney General concludes that Ashland's reasonable rate should be its wholesale rate of \$2.10.¹⁹

The Commission agrees with both Citizens and the Attorney General that Ashland's cost-of-service study is not the type which is typically filed by a local gas distribution utility. However, Ashland is not and has not been regulated as a gas distribution utility. Therefore, it has not been required to keep its records in a format that complies with the USoA. Nonetheless, the study does provide a useful list of cost categories which relate to the production and gathering of gas, and, to a lesser extent, costs which are related to farm tap service.

In determining a fair, just, and reasonable rate for farm tap service, Ashland should be allowed to recover its cost of gas, plus those costs directly related to providing service to its farm tap

¹⁸ Brief of Pike County Citizens United for Justice, page 4.

¹⁹ Brief of the Attorney General, page 6.

customers. Ashland should also be allowed to earn a reasonable return for providing this service. An approach frequently used by the Commission in determining fair, just, and reasonable rates is the "Operating Ratio Method." This method is used primarily when there is no sound basis for a rate of return on investment or capital devoted to providing utility service as is the situation in this case. The operating ratio generally used by the Commission to provide for equity growth is 88 percent on allowed operating costs, exclusive of gas costs. This methodology has been used to determine a fair return to Ashland based upon allowable operating expenses.

The Commission has analyzed the operating expenses of Ashland. Expenses which relate to gathering pipelines, compression, or wholesale sales activities should not be included as such costs should already be recovered in Ashland's wholesale price for gas (which Ashland uses as its "cost of product" for its proposed farm tap rate). To include such costs in the farm tap rate would allow Ashland to recover these costs, or a portion of these, twice--once in the cost of product and once again in the retail rate. Expenses included by Ashland in its proposed rate which were derived through cost allocations should also be disallowed because they are not adequately supported. Ashland failed to show that these expenses are not already recovered in its cost of product. To include these costs in Ashland's rate would result in farm tap customers partially subsidizing Ashland's exploration and production business.

Therefore, the Commission finds that Ashland's rate to its farm tap customers should be \$3.463 per Mcf, excluding the 370 former OXY customers who have been served and charged rates pursuant to right-of-way or lease contracts. These contracts are the subject of litigation in federal court (as more fully described herein).

In determining the \$3.463 rate, the Commission has included the \$2.10 cost of product and has provided a return of 12 percent of operating expenses based on the operating ratio methodology. The Commission has accepted Ashland's legal expenses, but amortized the total legal costs over 3 years. Ashland's costs represented as region office production²⁰ and gas sales²¹ have been deleted. Likewise, neither general and administrative costs nor interest expense is incorporated in the approved rate.²² Expenses described by Ashland as operating costs, depreciation, foreman, district office, and accounting have been included, less any allocated amounts, to the extent they were discernible in the cost-of-service study as direct costs. The Commission has incorporated

²⁰ T.E., page 41. Ashland testified that these costs were derived from ". . . merely an allocation on a volume basis."

²¹ T.E., page 42. Ashland testified that these costs included marketing and production of gas costs. Since Ashland does not solicit new KRS 278.485 customers, these costs should only apply to Ashland's wholesale market.

²² T.E., pages 61-62. Ashland testified that these expenses were allocations made from the corporate area. The interest expenses, in particular, represent Ashland Exploration's allocated portion of interest on payments made by Ashland, Inc. (the parent company).

an amount of bad debt expense appropriate for a 12-month period.²³ The amount proposed by Ashland includes expenses for more than 1 year's uncollectible accounts expense.²⁴ Ashland's customers who are current in payment should not be asked to pay for expenses incurred by Ashland which could have been reduced or eliminated under KRS 278.485(7).²⁵

Contract Rates

In 1990 Ashland acquired certain OXY gas properties in Kentucky, from part of which 960 domestic customers are served. According to Ashland, approximately 370 of these customers receive gas pursuant to either right-of-way or lease contracts and are paying 35 cents per Mcf for gas.

Ashland maintains that the Commission lacks jurisdiction over its rates for these 370 customers as the service to them is contractual, not statutory.²⁶ Ashland cites Section 19 of the Kentucky Constitution and Union Gas and Oil Co. v. Diles, 200 Ky. 188, 254 S.W.205 (1923) as support for its assertion that KRS 278.485 does not apply to service to these customers.

Citizens appears to have agreed with Ashland's argument in litigation filed by Citizens in federal court to interpret the pricing provisions of these contracts. Citing Dept. for Natural

²³ T.E., pages 58-59.

²⁴ T.E., page 55.

²⁵ KRS 278.485(7) grants a gas company the authority to disconnect service to farm tap customers who fail to pay their bills.

²⁶ Brief of Ashland Exploration, page 6.

Resources and Environmental Protection v. Stearns Coal & Lumber Co., Ky., 563 S.W.2d 471 (1978), Citizens concludes that the Commission lacks jurisdiction over rates to these customers.

Ashland asks the Commission to defer to the court for interpretation of the contract pricing clause. Citizens requests that the Commission order Ashland to maintain the 35 cents per Mcf rate until a final decision in the pending federal litigation is reached.

Because the interpretation of these contracts is pending in federal court, the Commission hereby finds that the \$3.463 rate should not apply to the 370 right-of-way or lease customers whose contracts stipulate a rate of 35 cents per Mcf. However, the Commission will review this issue upon conclusion of the federal litigation.

IT IS THEREFORE ORDERED that:

1. Ashland's rate to its farm tap customers shall be and hereby is approved as \$3.463 per Mcf.

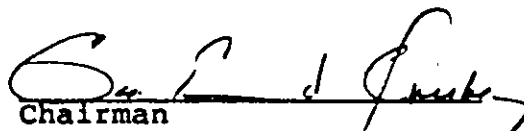
2. Pending the decision in Pike County Citizens United for Justice, et al., v. Ashland Exploration, Inc., U.S.D.C., E.D. Ky. (92-255), (filed July 27, 1992), Ashland's approved rate shall not apply to the former OXY customers who are served pursuant to right-of-way or lease contracts and have been charged 35 cents per Mcf. Within 10 days of the decision, Ashland shall submit to the Commission a copy of the court's judgment and shall further notify the Commission within 5 days of the judgment becoming final and not subject to appeal.

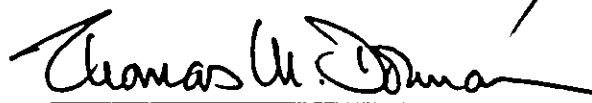
3. Within 30 days of the date of this Order, Ashland shall file with the Commission a tariff with its approved rate and conditions for service.

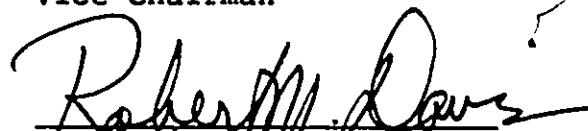
4. Within 10 days of the date of this Order, Citizens shall submit to Ashland an updated list of the names and addresses of the former OXY customers for whom the rate increase shall be deferred and file a copy of this list with the Commission.

Done at Frankfort, Kentucky, this 13th day of July, 1993.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director